LPL RESEARCH

WEEKLY ECONOMIC COMMENTARY

KEY TAKEAWAYS

The LEI provides a valuable monthly guidepost regarding the state of the current economic expansion.

Looking at past and present readings of the LEI provides added context for the potential direction of the U.S. economy.

Despite a recent weak reading, we do not think the LEI is signaling a recession in the near term, although global and policy risks remain.

July 25 2016

FOLLOW THE LEADERS

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The Conference Board Leading Economic Index (LEI), one of our Five Forecasters, provides a valuable monthly guidepost regarding where we are in the economic expansion. The latest reading on the LEI, based on June 2016 data, revealed that the index climbed just 0.7% since June 2015. The month-over-month change in the LEI has been negative half the time over the past year, while the year-over-year change has decelerated from a high of 6.7% in July 2014 to the 0.7% today. This weakness has many observers concerned that the LEI is signaling a recession. In our view, the recent weakness in the LEI reflects the impact of the stronger dollar, the fall in oil prices and resulting decline in oil-related capital spending, and the general weakness in the manufacturing sector that has beset the U.S. economy since oil prices peaked in mid-2014. As we noted in our recent *Midyear Outlook 2016: A Vote of Confidence*, we expect many of those factors to fade in the second half of 2016.

WHAT DOES THE LEI REPRESENT?

The LEI is designed to project the probable path of the economy 6–12 months in the future. Since 1960, a span of 678 months (or 56 years and 5 months), the LEI's year-over-year increase has been at least 0.7% (as it was in June 2016) in 487 months. Not surprisingly, the U.S. economy was not in a recession in any of those 487 months. Thus, the odds that the U.S. economy was in recession in June 2016 are close to zero. As we've noted in prior commentaries, when the economy has not been in a recession, the S&P 500 has been positive 82% of the time and provided low-double-digit returns. When the economy has been in a recession, the S&P 500 has been positive just 50% of the time, with average returns in the low-single-digits.

But the LEI is designed to forecast the potential direction of the U.S. economy and tell market participants what may happen, not what has already happened. Three months after each of the 487 months that the LEI was up 0.7% or more, the economy was in a recession just four times. Six months after the LEI was up by

THE FIVE FORECASTERS

There is no magic formula for predicting recessions and bear markets — every cycle is different. But we believe the Five Forecasters cover a variety of perspectives and help capture a more complete view of the economic and market environment. They are meant to be considered collectively, not individually. For more on the Five Forecasters and other components we're watching, see the latest Recession Watch Dashboard.

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0.7% or more on a year-over-year basis, the U.S. economy has been in a recession 12 times, or 3% of the time. Looking out 12 months after the LEI was up 0.7% or more, the economy was in a recession in just 33 of the 487 months, or 7% of the time. Based on this relationship, the odds of a recession within the next 18 months and 24 months are 11% and 12%, respectively [see the first chart in the infographic on page 3]; thus, despite the recent weakness in the LEI, the forward-looking economic indicators suggest that the odds of a recession in next few years are very low.

> The odds that the U.S. economy was in recession in June 2016 are close to zero.

Another way to look at the LEI is by its level relative to its prior peak [the second chart shown in the infographic]. Sometime in the next several months, the level of the LEI may reach its prior peak (125.0), hit in March 2006. As is often the case when any indicator hits an all-time high or reaches a prior peak, this may raise concerns that a negative downturn is ahead, and in this case, that the economic cycle is nearing an end. But in fact, during the last three economic recoveries (commencing in 1982, 1991, and 2001), the recovery continued, on average, for another 6 years after the LEI hit its prior peak. During the 1982–1990 recovery, the LEI finally hit its prior peak in November 1984, and the economic expansion continued for another 67 months (nearly 7 years) before entering a recession in July 1990. During the 1991–2001 recovery, the LEI hit its prior peak in December 1992, and the economic expansion continued for another 98 months (more than 8 years) before entering a recession in February 2001. During the recovery that began in 2001, the LEI passed its prior peak in January 2004, almost 4 years before the Great Recession began in December 2007.

WHAT IS THE LEI SUGGESTING FOR WHAT'S AHEAD?

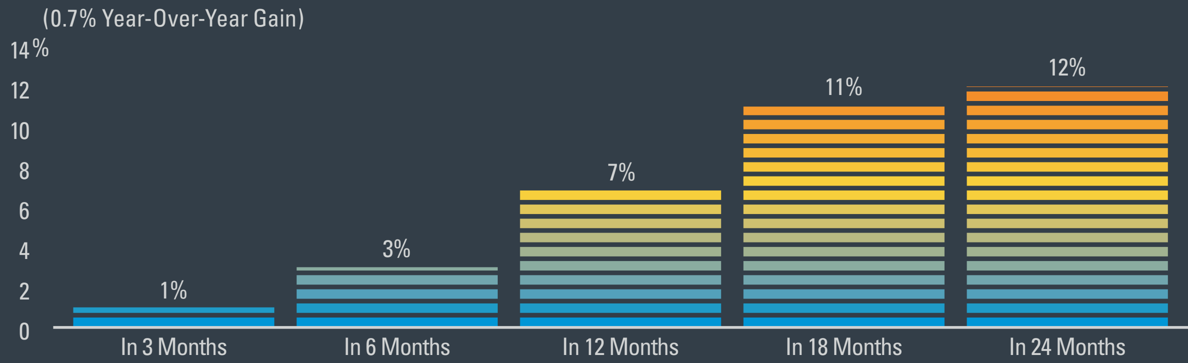
So, what happens next? Perhaps the LEI—past and present—can help answer that question. The deceleration in the LEI in mid-2014 coincided with the rise in the dollar, the drop in oil prices, and the subsequent decline in oil-related capital expenditures and manufacturing. Since that time, the average monthly gain in the LEI was 0.3%, which matches the average monthly gain in the LEI during the last three economic expansions (1982–1990, 1991–2001, 2001–2007). If the LEI averages 0.3% per month over the next 12 months, in June 2017, the year-over-year increase in the LEI would be 3.7%; this would suggest that the odds of a recession in the 12 months ending in June 2018 would be just 5%.

However, we believe the U.S. economy has the potential to pick up some steam in the coming quarter—not by much, but some—and could match the recovery to date gross domestic product (GDP) growth rate of 2.0–2.5%. During that time (mid-2009 through today), the average monthly gain in the LEI was 0.4%. If sustained over a full year, the 0.4% gain would translate into a robust 6.7% year-over-year gain in the LEI in June 2017, which would put the odds of recession occurring by June 2018 at just 3%. The infographic (the third chart) also shows what the LEI would look like a year from now at 0.1% and 0.2% gains per month.

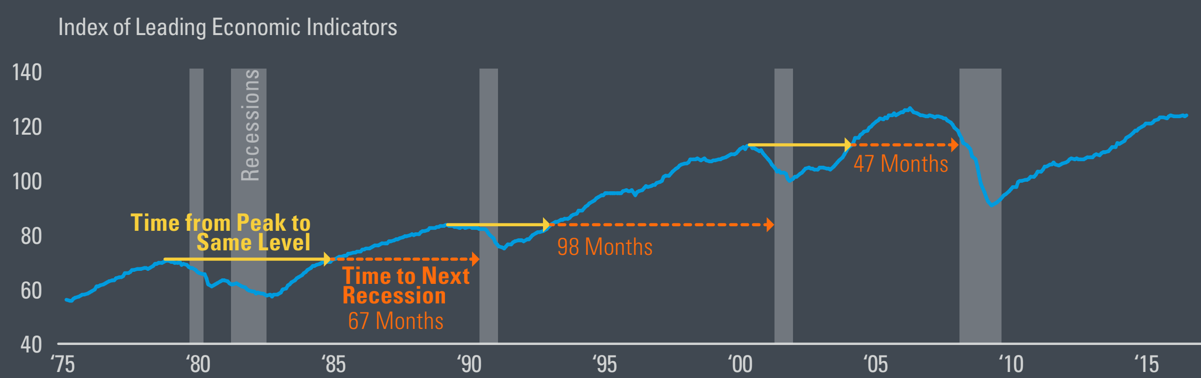
It is possible that the LEI doesn't move at all, as perhaps the uncertainty around Brexit tightens U.S. financial conditions; or a sharply stronger dollar puts renewed downward pressure on oil prices, capital spending, and manufacturing; or a policy mistake at home or abroad dampens growth. In that case, no change in the LEI would put the odds of recession occurring between June 2017 and June 2018 at just 8%.

The LEI and Odds of Recession

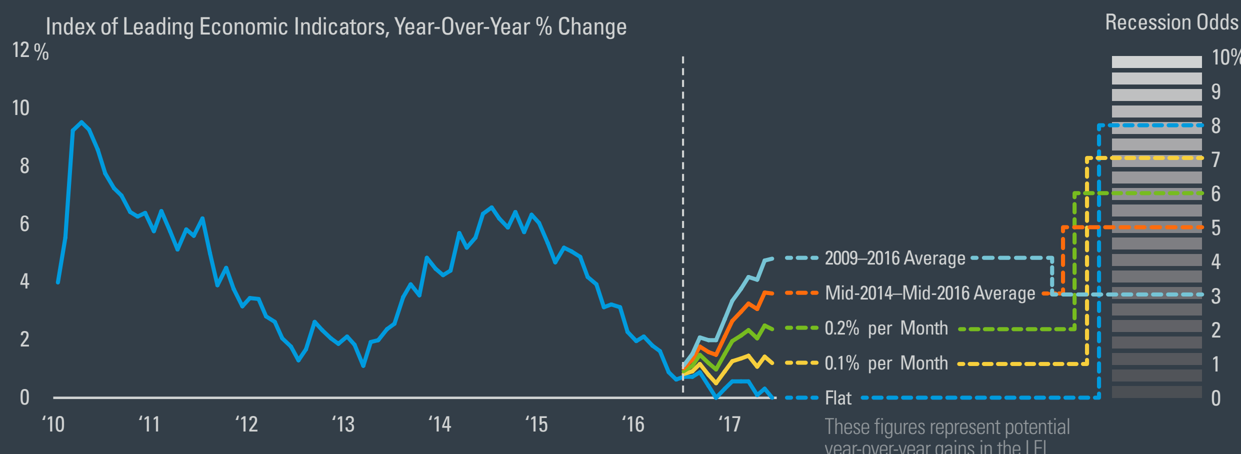
Odds of Recession Based on LEI Over Last 12 Months



Time Between Peaks and Following Recessions



Possible LEI Paths and Odds of Recession in 12 Months Based on End Points of Each



Source: LPL Research, Conference Board, Bureau of Economic Analysis, Bloomberg 07/22/16

Data are from 1960–2016.

The economic forecasts set forth in this presentation may not develop as predicted. Indexes are unmanaged and cannot be invested in directly. Past performance is no guarantee of future results.

The Leading Economic Index is a monthly publication from the Conference Board that attempts to predict future movements in the economy based on a composite of 10 economic indicators whose changes tend to precede changes in the overall economy.

On balance, the LEI, even at just 0.7% year over year, says the risk of recession in the next 12 months is very low (7%), but not zero; and based on the level of the LEI relative to its prior peak, the current economic expansion may last at least another 4 years. Although the odds of a recession increase when looking out 18 months (11%) and 24 months (12%), they remain low—but again, not zero. We note that economic recoveries do not generally die of old age, but end due to excesses building up in one or more sectors of the economy. In the past, overbuilding in housing or commercial real estate, borrowing too much to pay for overbuilding and overspending, or even overconfidence by businesses and consumers have all led to overheating and recession.

The current recovery has been relatively lackluster by historical standards, and the excesses that have triggered recessions in the past are not present. Still, a dramatic deterioration of the financial or economic situation abroad, a fiscal or monetary policy mistake here in the U.S. or abroad, or an exogenous event (a major terror attack, natural disaster, etc.), among other events, may cause us to change our view. ■

INDEX DESCRIPTIONS

The S&P 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.

The Conference Board Leading Economic Index (LEI) is a measure of economic variables, such as private sector wages, that tends to show the direction of future economic activity.

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